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Special Treatment Accorded Farmers Under the Current Income Tax Law

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SPECIAL TREATMENT ACCORDED FARMERS
UNDER THE CURRENT INCOME TAX LAW

A Thesis

Presented to
the Faculty of the Department of Taxation
College of William and Mary

In Partial Fulfillment
of the Requirements for the Degree
Master of Arts

by
Wesley R. Cofer, Jr.

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List of Abbreviations

1. US - The official reprint of the decision of the United States Supreme Court published by the Government Printing Office.
2. SCT - Supreme Court Reporter. Decision of the United States Supreme Court as reported by the West Publishing Company.
3. LEd - Lawyers' Cooperative edition of the United States Supreme Court decisions.
4. Fed. - Federal Reporter. The early decisions of the Federal Courts published by the West Publishing Company.
5. F2d. - Federal Reporter, second series. Decisions of the United States Circuit Court of Appeals beginning where the Fed. stops. Published by West.
6. F.Supp. - Federal Supplement. This compliments the F2d. reporting the decisions of the United States District Courts. Published by West.
7. TC or BTA - Decisions of the United States Tax Court, formerly the U. S. Board of Tax Appeals.
8. AFTR - American Federal Tax Reports. A reprint of all federal tax cases, published by Prentice Hall, Incorporated.

Court decisions are cited as 10 US 497, which means the case in print will be found in volume 10 of the official reprint of the decisions of the United States Supreme Court at page 497.

9. Rulings of the United States Treasury Department are cited as follows:

ARR - Committee on Appeals and Review recommendation,

GCM - General Counsels' Memorandum,

IT - Income Tax Unit Ruling,

Mim - Mimeograph letter,

O or LO - Solicitor's Law Opinion,
OD - Office Decision of Income Tax Unit,
S or SM - Solicitors' memorandum,
TD - Treasury decision.

10. DC - United States District Court.
11. CCA - United States Circuit Court of Appeals.
12. CB - Cumulative Bulletin of the Bureau of Internal Revenue of the Treasury Department containing the rulings specified in item 9. This Bulletin also contains reprints of cases selected by the Bureau.
13. Aff. or Aff'd - Affirmed. Denotes that a higher court has sustained the decision of the lower court.
14. Rev. or Rev'd - Reversed. Decision of a lower court reversed by the higher court.
15. Sec. - Section of the Internal Revenue Code or of the current Treasury Regulations if cited Sec. "29".

CHAPTER I

THE PROBLEM AND DEFINITIONS OF TERMS USED

Until very recently taxation was thought of in terms of property valuations, assessments and local governments. Taxes brought to mind mainly property taxes and if the thinker was in an argumentive mood, then he might possibly remember to fuss a little about the Federal Income Tax and what a nuisance it was to have to bother with as far as he was concerned.

With the increased governmental activities, the shift from local to central responsibilities and the increasing scope of national defense, all bringing enormously increased revenue requirements, it has been necessary to increase taxes until now the attention paid to tax problems often means the difference between whether an economic unit shows a profit or a loss.

I. THE PROBLEM

For various reasons not important to the purposes of this paper, the government decided to obtain this additional revenue by income taxes. As a result of this decision and the increased tax base necessary to carry it out almost every person in our society is acutely conscious of income taxes. Many books have been written covering the Internal Revenue Code, both specifically and generally, and there have been works on the practical side relating to how the ordinary farmer should fill out his

return, but since the Internal Revenue Code does not treat farmers as a separate classification, there is a paucity of writings presenting a comprehensive comparison of all the provisions as to farmers as contrasted with ordinary treatment of the point.

The purpose of this study was (1) to segregate all provisions in the Code relating to farmers; (2) to compare the treatment of farmers with other income recipients; and (3) to relate the provisions to the proper items on the Income Tax Forms.

II. DEFINITIONS OF TERMS USED

Accounting Period. The taxable year of the taxpayer.

Taxable Year. The taxable year can be either a calendar or a fiscal year. It is a fiscal year if it ends on the last day of any month other than December. In either case it must be twelve months unless the Commission directs otherwise. The books and records of the taxpayer must be kept on the same year.

Cash Receipts and Disbursements Basis. A method of accounting which is mandatory for the taxpayers who keep inadequate books or records. Under this method whether income or expenses occur in the taxable year or not is determined by when they are actually or constructively received or paid. It is not necessary that receipt or payment be made in cash.

Accrual Basis. The income is taxable when it is earned and expenses are deductions as soon as incurred. This form of accounting must be followed in businesses requiring inventories. Another way of stating

this requirement is that the accrual basis must be used where production, purchase or sale of merchandise is an income producing factor.

Basis. A term generally meaning the cost of property. Basis is the reference point for determining gain or loss. Basis generally is the cost of the property. The Internal Revenue Code sometimes requires that basis be adjusted to allow for tax advantages or disadvantages accruing to the taxpayer, this is called the "adjusted basis". The basis of the taxpayer may under some conditions be a "substituted basis " such as when property has been acquired by gift then the basis to the donor will be substituted and become that of the taxpayer. The basis to the taxpayer may be other than cost depending on the purpose for which the determination is made.

Taxpayer. For the purposes of this paper a "taxpayer" may be an individual, a partnership or a corporation. Where the provisions of the Internal Revenue Code treat any of the above in a different manner such treatment and the class of "taxpayer" it is applicable to will be specified.

III. ORGANIZATION

An attempt has been made to organize this presentation along the lines of a tax return. There will be a general examination of the requirements of the Code and particularly to whom it applies followed by a detailed discussion of the main items of a return. These may be outlined briefly as follows:

1. what may be excluded from farm income in the general economic sense to arrive at gross income for tax purposes,

2. what deductions are allowable for adjusted gross income,

3. what requirements must be met to constitute expenditures as other deductions to arrive at net income,

4. what exemptions may the farmer take to arrive at taxable net income. By treating the above items in slightly different ways certain tax advantages will be gained.

CHAPTER II

INTRODUCTION

I. FARMS AND FARMERS

The Regulations (See Appendix for all pertinent regulations.) define the term "farm" as embracing all that the term conotes in the ordinary sense in which it is used. This usage includes stock, dairy, poultry, fruit, truck farms, ranches, plantations and any land used for farming operations.¹ Strangely though, all people who operate farms are not farmers nor are farmers only people within the tax concept. The same section of the Regulations confines the term "farmers" to those operating a farm for profit whether they be individuals, partnerships or corporations if they cultivate, operate, or manage farms either as owners or tenants. Clearly this excludes so called "gentleman farmers" who operate or cultivate farms solely as a hobby, for pleasure or to take advantage of tax losses if they have continued losses from year to year. Whether a farmer is a "gentleman farmer" depends on his intention. Where the Bureau can prove his intention he will not be allowed any losses nor will his expenses be deductible, but he must still report any income arising from his farm activities.

Farmers are not a separate class of taxpayer and the provisions of the Internal Revenue Code governing farmers, their income, deductions

¹
Reg. III, Sec. 29.22(a)-7.

and rates of tax are those applicable to taxpayers generally. In spite of all of this, there are many provisions of the Code and Regulations (See Appendix for all pertinent regulations.) which give special treatment to farm income and expenses. It has been said that the special treatment is necessary because the farmer raises the products, the sale of which results in his gross income, and further that farmers are notoriously² poor at keeping accounts and records. Whether these reasons justify the special treatment or whether the special treatment is proved treatment or not is beyond the scope of this study.

II. DECLARATION OF ESTIMATED TAX

Every individual whose gross income from wages can reasonably be expected to exceed \$4,500 plus \$600 for each exemption or whose gross income from other sources can reasonably be expected to exceed \$100 and his gross income to be \$600 or more, shall make a declaration of his estimated tax for the taxable year. Such declaration shall be filed on or before March 15 of the taxable year or prior to June 15 or September 15 provided the requirements for filing are first met prior to the date of filing.³ The estimated tax shall be paid in equal installments on March⁴ 15, June 15, September 15 and January 15 of the succeeding taxable year.

²

Prentice Hall Federal Tax Service Vol.17234 p. 7154.

³

I.R.C., Sec. 58 & see Reg. III, Sec. 29.58.

⁴

I.R.C., Sec. 59.

The code further provides for prompt amendment if the estimate is not proving out. There is a penalty prescribed if the tax withheld at the source plus the estimated tax is less than 80% of the final tax.⁵

Farmers using the calendar year whose estimated gross income from farming is at least two-thirds his total estimated gross income from all sources for the taxable year, may file a declaration and pay the estimated tax on or before January 15 of the succeeding taxable year. If he prefers this procedure he must file his return and pay the balance of his tax on or before March 15. He may, in lieu of the above, file a return for the taxable year on or before January 31 of the succeeding taxable year and pay the tax in full. If the farmer follows this latter procedure he is not required to file a declaration. The penalty provided for substantial understatement of the estimated tax does not apply to farmers if the estimated tax was at least two-thirds of the final liability.⁶

If the taxpayer is on a fiscal year the corresponding dates of his tax year must be substituted for the dates specified above. Farmers, like other individual taxpayers, can file joint declarations with their wives. If the declaration is based on the preceeding years tax liability, the penalty for substantial understatement does not apply. Declarations are made on Form 1040ES.

⁷
Samuel M. Monatt recommends that the farmer is definitely better

⁵

I.R.C. Sec. 294(d) (2) & Reg. III, Sec. 29.294-1; (b) (3).

⁶

I.R.C. Sec. 60.

⁷

Monatt 1950 Farmers Income Tax on 1949 Income, Commerce Clearing House, Inc., 1949) p. 65.

off to file the declaration in January 15 in lieu of the tax return on January 31. He offers in support that the taxpayer has additional time, til March 15, to insure his return is correct and further, the taxpayer has the use of the additional money for sixty days at no disadvantages.

III. WITHHOLDING

Every employer making payment of wages shall deduct and withhold⁸ a certain amount prescribed from such wages. Wages or remuneration for⁹ labor agricultural/are specifically exempted from such withholding. I.R.C., Sec. 1426(h) specifies that:

The term "agricultural labor" includes all services performed--

(1) On a farm, in the employ of any person, in connection with cultivating the soil, or in connection with raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of live-stock, bees, poultry, and fur-bearing animals and wildlife.

(2) In the employ of the owner or tenant or other operator of a farm, in connection with the operation, management, conservation, improvement, or maintenance of such farm and its tools and equipment, or in salvaging timber or clearing land of brush and other debris left by a hurricane, if the major part of such service is performed on a farm.

(3) In connection with the production or harvesting of maple sirup or maple sugar or any commodity defined as an agricultural commodity in section 15(g) of the Agricultural Marketing Act, as amended, or in connection with the raising or harvesting of mushrooms, or in connection with the hatching of poultry, or in connection with the ginning of cotton, or in connection with the operation or maintenance of ditches, canals, reservoirs, or waterways used exclusively for supplying and storing water for farming purposes.

8

I.R.C., Sec. 1622.

9

I.R.C., Sec. 1621.

(4) In handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, any agricultural or horticultural commodity; but only if such service is performed as an incident to ordinary farming operations or, in the case of fruits and vegetables, as an incident to the preparation of such fruits or vegetables for market. The provisions of this paragraph shall not be deemed to be applicable with respect to service performed in connection with commercial canning or commercial freezing or in connection with any agricultural or horticultural commodity after its delivery to a terminal market for distribution for consumption.

As used in this subsection, the term "farm" includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards.

But the Regulations (See Appendix for all pertinent regulations.) expressly state that agricultural labor does not include services performed in connection with forestry, lumbering or landscaping. The effect of this

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same regulation though, is to include anything that is done as an incident to farming. But if the employer's business is something other than farming, even though a farmer might have occasion to do the same thing, it will not be agricultural labor. For example, services such as handling,

drying, grading and packing fruits or vegetables for a commercial handler would not be agricultural labor. All wages in a payroll period must be

11

treated alike. If the services performed during over one-half the payroll constitute wages then all payment for that period will be wages.

10

Reg. 116, Sec. 405.102(c) (1).

11

Min. 6219, Dec. 31, 1947; Min. 6219, Mar. 1, 1948.

12

I.R.C., Sec. 1622 (g).

IV. SOCIAL SECURITY, UNEMPLOYMENT AND INFORMATION RETURNS

Likewise, farmers are not subject to the provisions of the Social Security Act ¹³ or to the provisions of the Unemployment Compensation Act. ¹⁴ If the farmer does pay more than \$600 to his hired hand the farmer is required to file the appropriate information returns. Forms 1096 and 1099 must be filed for domestic help as well as for the farm help. The \$600 need not be cash; if the farmer furnishes things of value to the help the value to the laborers must be reported. But room and board furnished help will not constitute wages to the help if he is required to live on the farm, for the convenience of the farmer. This rule is of importance only to the wage earner, it must be carefully distinguished from the rule used to determine whether or not these are deductible to the farmer and the amount of such deduction. A copy of Form 1099 should be given to each worker. Form 1099 must also be filed if \$600 or more is paid in rent or interest to any individual not a real estate agent or corporation.

¹³

I.R.C., Sec. 1400; I.R.C., Sec. 1426(h).

¹⁴

I.R.C., Sec. 1600; I.R.C., Sec. 1607.

CHAPTER III

PRELIMINARY MATTERS

The requirements for filing returns are generally the same as for all other taxpayers. However, as an aid to the farmers, the government allows them to use a supplementary form which is not only convenient, but in addition lists all of the items of income and deductions relating to farming.

I. FORM 1040 F AND OTHER FORMS

Any individual with the requisite income must file a tax return. Which form the taxpayer will report on, depends upon his classification. If he is an individual he will report on Form 1040 (1040A in cases with which we are not concerned.) If the taxpayer is a corporation the return will be a Form 1120. Partnerships, although not taxed, use Form 1065 serving the purpose of an information return. In addition to filing a return, the Code imposes a duty on taxpayers to supplement their returns with such statements or schedules as are necessary to disclose in full the situation of the taxpayer.

Form 1040F fills just such a purpose. Form 1040F is titled Schedule of Farm Income and Expenses and it is no more; it is not a return form. The schedule lists items of income and deductions and by inserting the proper amounts the farmer is able to arrive at net profit or loss from farming, which is then transferred to the proper place on the taxpayer return form. Any farmer taxpayer can use the form as a schedule whether

he is an individual, partnership or corporation. Accrual basis taxpayers as well as those on the crop basis may also use this form. The schedule is mandatory only for farmers who keep in adequate records and those who elect to report on the cash basis.

15

II. RECORDS AND ACCOUNTING METHODS

Regulation 111, Sec. 29.54-1 states:

Every person subject to the tax, except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1. . .

While it is clear from the above authorization that farmers do not have to keep books and records certain consequences accompany the election not to do so. Any taxpayer choosing not to keep records must use the calendar year as his tax year. He must report his income and deductions on the cash receipts and disbursements basis. Further, the Bureau puts the burden upon any taxpayer to satisfy the Commissioner that his tax return clearly reflects his income. If this burden cannot be met, which is difficult to do in the absence of records, the results may be disastrous. The Commissioner is authorized to determine the taxpayer's income by several rather arbitrary methods which may result in a much higher income and tax than the true one.

Taxpayers who compute their income for a calendar year, unless

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Reg. 111, Sec. 29.22(a)-7.

they do so because they fail to keep adequate records, and those taxpayers using the fiscal year may choose to compute their income on the accrual basis. The Commissioner has ruled that farming is not a business in which¹⁶ inventories must be kept to properly reflect income, but the accrual method is dependent upon inventories and the method cannot be used unless inventories are kept. Still it appears to be advantageous to the farmer to use the accrual basis since it generally will result in a more uniform tax liability. Regardless which accounting period (calendar or fiscal) or which accounting method (cash or accrual) is chosen, it must be used consistently until the Commissioner authorizes a change.

There is a third method of accounting which is available to farmers. If the farmer is engaged in producing crops which take more than a year to grow, it would be very unjust to the farmer to take most of his deductions for the cost of producing in one year and have to report his income from the sale in the next year. To avoid this situation a farmer may, with the consent of the Commissioner, take the entire cost of producing the crop as a deduction for the year the sale is effected and the profit made.¹⁷ It was stated above that the crop basis was a third type of accounting method; but this is not exactly true, since the crop basis is not a method in and of itself, but can only be used in conjunction with either the cash or accrual methods. The crop basis is necessitated by the fact that crops prior to maturity are generally not inventoried.

¹⁶

Bureau letter, 8-30-23.

¹⁷

Reg. 111, Sec. 22(a)-7.

Prior to December, 1948 the Tax Court held that changing from the cash basis to an inventory method, by merely complying with the requirements of the Code, was a special privilege or right extended to farmers and such change did not require the prior consent of the Commissioner.

In light of this decision the Regulation now states:

Formal application for permission to change from the cash receipts and disbursements basis to an inventory basis of accounting shall not be required in the case of a change made for a taxable year beginning before December 30, 1948, the date of approval of Treasury Decision 5683.

In any change of accounting from the cash receipts and disbursements basis to an inventory basis, whether made for a taxable year beginning before or after December 30, 1948, adjustments shall be made, at the option of the taxpayer, in accordance with one or the other of the two methods outlined in (1) and (2) below:

.....

By method (1) opening and closing inventories of all farm products on hand must be used for the year of change. "All farm products" includes livestock and there is no distinction made between whether products were raised or purchased. Estimates may be made of the inventories and if the Commissioner is satisfied that they substantially reflect the preceding years inventory income, they will be accepted. These inventories or estimates will be the basis for an adjustment sheet which must be submitted adjusting the preceding years income to an inventory basis. If, in the opinion of the Commissioner, the previous or subsequent income will still be distorted, he may require that the taxpayer adjust for more than just the one year.

18

T.D. 5683, Dec. 30, 1948.

19

Kenneth S. Battelle et al, 9 TC; Angel Milani et al, 47, 280 P-H. Memo TC.

20

Reg. 111, Sec. 29.22(c)-6.

Under method (2) net income is computed in the year of change without deducting therefrom the value of the beginning inventory, except to the extent that it includes the cost of products on hand at the beginning of the year, which had not been charged to expense in the previous year. When this method is used, no adjustment sheet is necessary.

To make any change in accounting method, application must be made to the Commissioner within 90 days after the beginning of the tax year to
²¹ be covered by the return. The entire process is not as smooth as it first appears and there has been much litigation over it. It has been held that a farmer desiring to change from the cash receipts and disbursements basis to the accrual basis may include in his inventory, inventorial assets on hand, that he can establish to the satisfaction of the Commissioner,
²² were held prior to the first year in which he was taxed. The change from cash to accrual basis has been denied because the taxpayers records were
²³ on the cash basis; because the change was requested on the last day of the
²⁴ taxable year; because the return had previously been filed on the cash
²⁵ basis and amendment on the accrual basis was sought. Where the change is directed by the Commissioner, the taxpayer need not secure formal

²¹

Reg. 111, Sec. 29.22(c)-6.

²²

OD 481, CB June 1920, p. 60.; OD 636, CB Dec. 1920, p. 80.

²³

OD 977, CB Dec. 1921, p. 67.

²⁴

OD 1113, CB Dec. 1921, p. 79.

²⁵

Strong v. Willcuts (DC Min); 17AFTR 1027.

permission to change in compliance with the Regulation. In some cases consent of the Commissioner will be implied from his acceptance of a changed method, with rejection.

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As to changes from the cash receipts and disbursements basis to the crop basis, the following Income Tax Unit Ruling summarizes the situation thusly:

The Bureau is not unmindful that the United States Board of Tax Appeals has uniformly held that there must be consistency of treatment with respect to items of income and deduction within the taxable period under the method of accounting employed. Where the practical application of this rule works to the detriment of the taxpayer with respect to previously taxed income, the Board has not been uniformly sustained. Prior to the promulgation of this rule by the Board, the Bureau had for many years granted applications for accounting changes, in the absence of some exceptional distortion of income, on the basis of picking up in the year of change all previously nontax-paid items of deduction. Since the promulgation of the Board decisions the Bureau has denied such applications unless the taxpayer and the Commissioner mutually agree as to the adjustments to be made in connection with the change. The taxpayer is not being forced by the Bureau to change its accounting method. The Bureau is willing to meet the taxpayer's accounting convenience, but is constrained to hold that permission to change will not be granted on a basis which ultimately defeats the revenue by means of permitting double deductions. A taxpayer desiring to change its method of accounting from the cash receipts and disbursements basis to the crop basis will be required to incorporate in its application, as an inseparable term and condition thereof, an agreement to eliminate previously deducted items of expenditure.

In the instant case, therefore, as a condition precedent to the granting of permission to make the change for the calendar year 1931, the taxpayer must agree that any expense of planting, cultivating, and otherwise producing the crop which was incurred prior to January 1, 1931, and previously claimed as a deduction on the cash basis, may not again be deducted in 1931 or any subsequent

26

Gus Blass Co., 9 TC 15, dismissed (CCA-8; 1948) 168 F.(2d) 833, 36 AFTR 1133; Reynolds Cattle Co., 31 B TA 206.

27

Gus Blass Co., loc. cit.; S. Rossin & Sons, Inc. v. Comm. (CCA-2; 1940), 113 F.(2d) 652, 25 AFTR 440, affirming on this point 40 B TA 1274.

year. Otherwise, the taxpayer must continue to report income for Federal income tax purposes on the basis presently employed by it.

Office Decision 841 and Mimeograph 3180, to the extent that same are inconsistent herewith, are revoked.²⁸

The crop basis method can be very beneficial to the farmer as some of the cases arising from it indicate. While engaged in planting, cultivating and marketing sugar cane, an operation extending over a three year period, the taxpayer suffered a very expensive strike. Held, that since the taxpayers accounts were on the crop basis, losses caused by strike should be handled the same as any expense of the crop and deducted²⁹ in the year of sale. Where the taxpayer used the crop basis on three year crops and its rent was payable in a percentage of the produce. Held, the rental was properly chargeable against the crop from which it was paid³⁰ and deductible as an expense of producing that crop.

Similar results are arrived at by the treatment afforded to Commodity Credit Loans under the Code. At first, advances under loan agreements from the Commodity Credit Corporation were treated as loans from³¹ any other source. The result of such treatment was that the farmer incurred his expenses when planting the crop and had to take his deductions

²⁸

IT 2614, CB June 1932, p. 48; Cf. National Bank of South Carolina v. Lucas, 36 F.(2d) 1013 (8 AFTR 9942), and Jacob Bros. Co. v. Commissioner, 50 F.(2d) 394 (10 AFTR 4.)

²⁹

Kahuku Plantation Co., 12BTA977, modified in 13BTA292. Oahu Sugar Co. Ltd., 13BTA404. Ewa Plantation Co., 13BTA625. Kekaha Sugar Co., Ltd., 13BTA690 (modified and aff'd, 60 App. DC 172, 50 F.2d 322, 9 AFTR 1653).

³⁰

Kekahu Sugar Co., Ltd., loc. cit.

³¹

IT 2931, CB Dec. 1935, p. 56.

there, but he did not receive the income from the crop until a later year. Now the Code provides that the taxpayer can elect to treat the "loans" as income when received, or wait until the crops are actually sold and treat that as the time of income receipt.³² Once an election is made it is binding on the taxpayer until the Commissioner authorizes a change. If, when the crop is sold it brings a greater amount than the "loan", the addition is income at the time of the sale. Taxpayers electing to include Commodity Credit Corporation loans in gross income must file a statement showing the details thereof.

In 1924, the Income Tax Unit decided that advances received by cotton growers, on the cash basis, under marketing agreements with cooperative sales associations whereby all the cotton raised by each grower was sold to the association and resold by it, proceeds later being distributed to the growers based on the amount of goods delivered to the association, were to be reported as income in the year received.³³ Similarly in 1938, the Income Tax Unit decided that amounts which the taxpayer expects to receive as conditional payments under the Sugar Act, should be reported as income for the taxable year in which such payments were authorized by the Secretary of Agriculture.³⁴ The taxpayer in the latter case was on the accrual basis. While both of these cases are consistent with the treatment usually accorded items under their respective basis methods,

³²

I.R.C., Sec. 123.

³³

IT 2107, CB Dec. 1924, p. 74.

³⁴

IT 3187, CB 1938-1, p. 159.

it is possible that they might be decided differently in light of the new chapter of the Code (123). The Code does specifically deal with Commodity Credit Loans, but it is conceivable that the option offered there might be extended.

CHAPTER IV

INVENTORIES

I. WHAT MAY BE INVENTORIED

The purpose of inventories is to more correctly reflect the true income of the taxpayer. To correctly reflect the income it is necessary to know what should be included in an inventory. The rules for taxpayers generally direct that they should include all finished or partly finished goods which were acquired for, or have physically become a part of the merchandise held for sale. This definition necessarily includes some raw materials and supplies, but only if they are held for sale. The Regulation specifies that this includes containers, bottles, kegs and cases, whether returnable or not, provided the title passes to the purchaser.³⁵ Items are not properly a part of inventory until the title passes to the taxpayer, therefore, unless the passage of title is dependent upon it, physical possession is immaterial. Depreciable property may never be included in inventory.

The items that are inventoried to the farmer are for the most part consistent with the general rule. It is required that all products raised or purchased for sale, including livestock, must be inventoried if the farmer is on the accrual basis. Standing or planted crops are not properly included in inventory. Nurserymen may inventory their young trees only when

³⁵

Reg. 111, Sec. 29.22(e)-1.

they have reached a marketable size and stage of development.³⁶ On the contrary, immature cattle are inventoried generally, at cost to date when the farmer is raising them. Cattle purchased for use as work or breeding animals or for use in the dairy business have been held properly included in inventory at the option of the taxpayer.³⁷

II. VALUATION OF INVENTORY

The rule universal to all industries is that inventories should be taken on the basis "(a) cost, or (b) cost or market, whichever is lower."³⁸ But, since the Regulation provides that valuation of inventories must conform to accounting practices in the business and must clearly reflect income, there can be little uniformity as to valuation methods. The Bureau requires only that the method used be merely in substantial accord with the Regulations provided the taxpayer is consistent. It is often difficult, in some industries, to determine accurately the cost; and it has been held in such cases that the market price may be reduced by an amount sufficient to eliminate profit and the result used as cost. Farming was designated specifically as such a business.³⁹ Cost in the case of purchased goods is the invoice price plus the expenditures necessary to reduce the item

³⁶

I.T. 1368 CB June, 1922, p. 72.

³⁷

Pevely Dairy Co., 1 BTA 385.

³⁸

Reg. 111, Sec. 29.22(c)-2.

³⁹

O. 844, CB 1919, p. 59.

to possessing or use. In the case of articles produced, cost usually includes materials, labor and expenses. If the items were inventoried in the previous year, the value to be used in the beginning inventory will be that used in the previous years closing inventory.⁴⁰ If similar lots of inventoried articles have been intermingled so that identity, in relation to the differing cost of each, is lost and some are sold,⁴¹ those remaining will be deemed to be those last purchased. This rule is called the "first-in, first-out" rule. The taxpayer is not bound to follow this rule, for regardless of loss of identity or the character of his business, he can secure permission from the Commissioner to treat items he specifies, under the "last-in, first-out" rule. Under the "last-in, first-out" rule those items left on hand are deemed to be those first acquired.⁴² This is called the "elective method" of inventoring. The "elective method" is applicable only if cost is used.

III. SPECIAL FARM VALUATION METHODS

A farmer may disregard all of the methods mentioned above and use the "farm-price method." The starting point when using this method is the market price. The market price is reduced by the amount of the direct cost of disposition. To change to this method of valuing inventories,

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Reg. 111, Sec. 29.22(c)-3.

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Reg. 111, Sec. 29.22(c)-2.

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Reg. 111, Sec. 29.22(d)-1.

the Commissioner's approval must be secured. If the Commissioner approves the election it must be followed for the entire inventory except livestock which may be valued by the "unit-livestock-price method."⁴³ This election too, must have the prior consent of the Commissioner.

The "unit-livestock-price method" provides for the adoption by the farmer of a reasonable classification of the animals in his inventory with respect to age and kind. A standard unit price is the set for each animal within the class. This method is only available to farmers who raise livestock. If such farmer has previously valued his inventory on the basis of cost or cost or market, whichever is lower, and desires to adopt the "unit-livestock-price method" for a year subsequent to December 31, 1943, he does not need the permission of the Commissioner. This method must be applied to all livestock raised, whether for sale, draft, breeding or dairy purposes. Animals purchased for draft, breeding or dairy purposes can be treated as inventory or as capital investment subject to depreciation after maturity. The cost of immature animals should be increased each year in accordance with the unit prices except in the event of purchases made during the last six months of such year, no adjustment should be made in that year. Upon subsequent disposition the "first-in, first-out method" should be used if the animals can not be identified.

Case decisions on inventory methods are numerous. If the taxpayer has used an inventory method but the Commissioner deems his records in-

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I.R.C., Sec. 22(c).

adequate, the income should be computed on the cash receipts and dis-
bursements basis.⁴⁴ The taxpayer valued his inventory at double the

amount he thought the banks would loan him on his cattle; held, no relation-
ship to cost, disapproved.⁴⁵ Likewise, where the taxpayer kept no records

inventories prepared at the time of making the return from his recollection,⁴⁶
held not permissible. A farmer using an inventory method may not value

his crops on hand at years end in excess of the cost of raising them.⁴⁷

Valuing inventories of livestock at a "constant price" has been disapproved.⁴⁸

In the last case, the Board of Tax Appeals also held that in computing
cost, for inventory purposes, it is proper to apportion the cost of main-
taining the breeding animals to the animals born during the year, but that
death losses may not be so apportioned.

⁴⁴ IT. 1673, CB June 1923, p. 30.

⁴⁵ Charley W. Peterson, Sec. 45, 108 P-H Memo TC.

⁴⁶ C.E. Clark, Sec. 42, 098 P-H Memo BTA.

⁴⁷ O. 844, CB 1919, p. 59.

⁴⁸ Estate of Cornelia Adair, 43 BTA 384.

CHAPTER V

GROSS INCOME

I. EXCLUSIONS

The gross income of farmers, as is the general rule with other individual taxpayers, includes total income from all sources. One exception occurs when products are raised by the farmer and consumed by his family. The value of such products is not income to the farmer. The Board of Tax Appeals has held that, . . . "It is obvious that such items are comparable to the rental value of a private residence, which has never been regarded as income or as a factor in the determination of tax liability."⁴⁹ But where a sole proprietor of a business of selling provisions made withdrawals for personal and family use, the Income Tax Unit ruled that he must subtract either the cost of such provisions from his total purchases⁵⁰ for the year or add such cost to his total sales.

II. INCLUSIONS

The items of gross income to farmers reporting on the cash receipts⁵¹ and disbursements basis are suggested broadly by the Regulations. Gross income shall include (1) the amount of cash or the value of merchandise

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Homer P. Morris, 9 BTA 1273.

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IT 998, CB Dec. 1921, p. 86; P.P. Sweeten, 3 BTA 37; Fellipo Dicenso, 11 BTA 620; T.J. Francis, 2 BTA 1087.

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Reg. 111, Sec. 29.22(a)-7.

or other property received during the taxable year from the sale of livestock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any items purchased, including livestock, and (3) gross income from all other sources.

If the farmer uses the accrual basis, his gross profits are found by adding to his closing inventory the amount received from the sale of livestock and products, and all miscellaneous receipts during the year, and deducting from this sum the beginning inventory value and the cost of livestock and products purchased during the year.

Gross income from all other sources, in the case of a cash basis taxpayer and miscellaneous income receipts, in the case of accrual basis taxpayers, apparently cover the same items. It should be noted that all of the items of gross income covered so far are items which are used to determine the farmers' profit from farming and all are used in computations on form 1040 F. There are many other items of income that must be included in gross income but not necessarily figuring in profit from farming. Due to the mechanics of the forms these other items are handled in separate schedules on the return form. An example of such an item would be the gain from the sale or exchange of capital assets (in some cases, farm animals), which would be treated separately in "Schedule D - Gains and Losses from Sales and Exchanges of Property" found on form 1040.

III. VALUATION OF INCLUSIONS

Simply stating which items are includible for gross income purposes does not solve the entire problem. Just as important is the problem of how much of the item is included.

Receipts other than cash -

When a farmer sells his livestock or produce for merchandise or other property, he should include as income the fair market value of the property received.

Profits from purchased items -

The profits from the sale of items purchased, including livestock are determined by deducting the tax basis from the sale price. This difference is the amount that is included in gross income. This treatment is very different from that directly above. In the preceding item, concerning sales of products raised, the entire proceeds are included in gross income because the expenses in connection therewith will have been previously deducted if they were incurred or paid in a prior year. Under the treatment of products purchased the tax basis is deducted regardless of when the purchase was made. The tax basis generally is the cost less the depreciation allowable.

Miscellaneous income receipts

The Regulation specifies that miscellaneous income receipts must be included. These items usually are easily handled such as cash received for the hire of teams, machinery and the like to neighbors.

Miscellaneous income receipts are also called "other farm income" items and include such things as:

- Receipts from wood and lumber
- Breeding fees
- Work off farm
- County fair prizes
- Recovery for hail and fire insurance on crops

Commodity Credit Loans -

Such loans may be treated as loans and not gross income or if the taxpayer formally elects, the loan may be treated as income in the year received. If later the crop is sold at a price in excess of the loan, which had previously been treated as income, such excess is further income.

Receipts from crop share rents -

When a tenant pays his farmer landlord rent in shares of his crops, they are income to the farmer only when reduced to money or its equivalent, and only to that amount. It makes no difference whether the taxpayer is on the cash or accrual method, except with the latter, the farmer should be careful not to include such shares in his inventories.

Agricultural program payments -

Payments made to the taxpayer under any of the government's agricultural programs are income in the amount of the payment, ⁵² unless they

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Decisions under different acts - IT 2976, CB June 1936, p. 138; IT 2767, CB June 1934, p. 35; IT 2992, CB Dec. 1936, p. 75; Baboquivari Cattle Co., 47 BTA 129, aff'd (CCA-9; 1943), 135 F.2d 114, CT.D. 1588, 30 AFTR 1386. Clara Driscoll, Sec. 44,021 P-H Memo TC modified without discussion of this point, Driscoll v. Comm. (CCA-S; 1945), 147 F.2d 493, 33 AFTR 704; G.A. Stafford & Co., Inc. v. Pedrick (DC, N.Y.; 1948), 78 F.Supp 89; Sec. 72, 485 P-H Fed. 1948, aff'd (2 Cir.; 1948), 171 F.(2d) 42; Sec. 72, 646 P-H Fed. 1948.

are received for amounts expended on capital assets, in which case they are reductions of cost.

Gifts made by a farmer -

Farmers donating products, they have raised, to charitable organizations are required to include the fair market value of such contributions in their gross income.⁵³ Likewise, a farmer who made a gift to

his son of cattle he had raised is required to include their fair market value,⁵⁴ at the time of the gift, in his gross income. The Income Tax Unit said this conclusion was based on the theory of an assignment of the donor's right to income.

Patronage dividends -

Patronage dividends are refunds or rebates paid to a farmer because he is a patron of a cooperative that markets his products or sells him his supplies. The rules regarding patronage dividends are succinctly stated as follows:

Farmers who market produce through a cooperative should add to the sales price of the produce, or to ordinary income, any patronage dividends received in the taxable year as a result of such transactions. Farmers who buy, through a cooperative, implements, gasoline, seed, fertilizer, or other items for use in their business should either reduce their deductions for such items by the amount of patronage dividends received or add patronage dividends to income. Patronage dividends received as rebates for purchases of items not used in your business should be omitted from your tax return. Patronage dividends are considered paid to you when remitted in cash, merchandise, stock certificates, or when credited to your account.

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I.T. 3910, CB 1948-1, p. 15.

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I.T. 3932, CB 1948-2, p. 7.

IV. SALES OF PROPERTY

The rule was stated above that profit on sales of property must be included in gross income, while this is true, not all profitable sales are taxed on the full amount of the profit. When capital assets are sold or exchanged, the results are a capital gain or loss. If the capital asset has been held for more than 6 months the gain or loss is long-term; if held for 6 months or less, the gain or loss is short-term. If the gain is long-term, only one-half the amount is taken into account; if short-term, the entire amount of gain or loss is taken into account. Long-term and short-term capital gains and losses are thus combined, resulting in a net capital gain or loss. A net capital gain is included in income, but a net capital loss is allowable in the year of loss only to a maximum of \$1000, the rest being carried forward for a total of 5 years if not used up sooner. The relief provision which limits the rate at which a net long-term capital can be taxed is the same for farmers as for other taxpayers.

The law defines capital assets negatively as:

. . . property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;⁵⁵

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I.R.C., Sec. 117(a).

The exclusion of stock in trade or inventory property and property held primarily for sale to customers, in effect, excludes the sale of products raised or purchased for resale by the farmer. Sales of investments, residential property and personal automobiles are capital assets common to farmers. Of course, although gains from the sale of the last two are treated as capital gains, losses therefrom would not be deductible since the transactions are not entered into for profit.

A relief provision in the Code has broadened considerably the scope⁵⁶ of assets which may benefit from capital asset treatment. This section is entirely in favor of the taxpayer. It applies to depreciable property and real property, and timber under some conditions. As a result of the treatment prescribed therein, if the total of the "117 J" transactions is a net gain, the transactions are treated as long-term capital gains and losses and therefore, only one-half of the actual gains and losses are taken into account. If the "117 J" transactions result in a net loss, then the section is not applicable and the transactions are treated as ordinary gains and losses, i. e. the net loss is fully deductible.

For a transaction to be a "117 J" transaction, there must have a sale or exchange or an involuntary conversion of such property after it had been held for more than 6 months. In addition to the foregoing, the property must be used in the business. An involuntary conversion is de-

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I.R.C., Sec. 117(a).

scribed as condemnation, seizure, destruction, theft and similar losses. The involuntary conversion provision can be applied to capital assets too.

Animals, whether raised or acquired for draft, breeding or dairy purposes if held for more than 6 months meet the requirements of Sec. 117(j). The Bureau has ruled that the inclusion of the above animals in inventory is immaterial since it is done by the farmer merely as an accounting convenience.⁵⁷ When such livestock are sold the opening inventory must be adjusted to show their transfer to the capital asset account. The Commissioner apparently considers the treatment in this paragraph, which has been approved by the courts, is too broad.

According to the court, for a transaction to come under 117 (j) it is incumbent upon the seller to show:

- (1) that the animals sold were used in his trade or business;
- (2) were subject to allowance for depreciation; (3) were held for more than 6 months; (4) were not property of the kind includible in the seller's inventory if on hand at the close of the taxable year; (5) that the animals were not held primarily for sale to customers in the ordinary course of his trade or business.⁵⁸

From all indications, it is conceded by the Commissioner that such animals are used in the trade or business of farming and that they are property subject to allowance for depreciation. The Commissioner is contending that the animals are held primarily for sale to customers and that they are property of the kind includible in inventory. It is strange to note the Commissioner's contention on the latter point, since the Bureau has ruled that the fact that livestock have been included in inventory is immaterial. This Bureau ruling has had the full support of the courts

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I.T. 3666, CB 1944, p. 270.

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Albright v. U.S. (8 Cir.; 1949), 173 F.2d 339, Sec. 72, 381 P-H Fed. 1949.

which have faced the issue.

In the *Alright* case the court rejected the Commissioner's contention that "culls" from a breeding herd are held primarily for sale to customers and in so doing rejected the prima facie test which had been imposed by Bureau ruling. Under the test, if the number of animals sold during the year exceeded the raised animals added to the breeding herd during the year, then the excess sold would be presumed to be held for breeding purposes; if the reverse were true, then none of the animals sold were to be considered subject to 117(j).⁶⁰

Since most farmers are not engaged in the business of lumbering, generally, standing timber on the land of a farmer is a capital asset. The Code provides that if a farmer cuts timber that he has owned more than 6 months, he can elect to treat the cut timber as though sold standing. If the farmer so elects, the difference between the fair market value of the standing timber and the adjusted basis of the felled timber is treated as a "117 J" transaction.

Some interpretations of the Code provisions as to capital assets follow: Feeder cattle are not capital assets nor are the "117 J" assets;⁶² If capital assets are sold in excess of O.P.A. ceiling price, the excess

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Fawn Lake Ranch Co., 12 TC 153; *Issac Emerson*, 12 TC 115.

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I.T. 3712, CB 1945, p. 176.

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I.R.C., Sec. 117(k).

⁶²

I.T., 3932, CB 1948-2, p. 7.

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is ordinary gain; Where citrus groves are sold with fruit on the trees, the gain allocable to the fruit is ordinary income and that allocable to the land and trees may be treated as "117 J" transaction.

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I.T. 3811, CB 1946-2; p. 70.

CHAPTER VI

DEDUCTIONS

I. FARM EXPENSES

The general rule regarding farm expenses is that a farmer may deduct all expenses necessary to the business of farming. The most common types of deductible and non-deductible expenditures follow:

Deductible expenses

- Wages paid hired help.
- Cost of board for use of hired help.
- Rations purchased and furnished sharecroppers.
- Feed purchased (grain, hay, silage, mill feeds, concentrates and other roughages, and cost of grinding, mixing, and processing feed).
- Machine hire (payments for use of threshing, combining, silo filling, baling, ginning, and other machines).
- Seeds and plants purchased.
- Supplies purchased (spray material, poisons, disinfectant, cans, barrels, baskets, egg cases, bags, etc.).
- Repairs and maintenance of farm buildings, fences, drains.
- Repairs and maintenance of farm machines and equipment.
- Small tools (shovels, rakes, etc.).
- Breeding fees.
- Fertilizers and lime (cost of commercial fertilizers, lime, and manure purchased during the year, the benefit of which is of short duration).
- Veterinary and medicine for livestock.
- Gasoline, other fuel and oil for farm business.
- Storage and warehousing expense.
- State and local taxes on farm business property.
- Insurance on farm property, except farmer's dwelling (buildings, improvements, equipment, crops and livestock).
- Interest on farm notes and mortgages.
- Water rent (farm share of expense).
- Electricity (farm share of expense).
- Telephone (farm share of expense).
- Rent paid in cash.
- Automobile upkeep expense (farm share).
- Blacksmith and harness repair.
- Bookkeeping service.
- Subscription to farm journals.
- Travel expense connected with farm business.

Deductions not allowable

Value of products raised by farmer and used for board of hired help.

Wages paid employees engaged solely in household work.

Expense of raising products consumed by farmer and his family.

Value of labor of farmer, his wife, or minor children.

Insurance on farm dwelling.

Repairs to building used as farmer's dwelling.

Federal income, estate and gift taxes.

Capital expenditures (purchases of machinery and equipment, improvements to barns and farm buildings).

Share of automobile upkeep and depreciation not applicable to farm business but related to personal or family use.

Loss of prospective crop by storm, flock, or fire.

Expenses of farm operated for recreation or pleasure.⁶⁴

Other more troublesome expenses will be treated separately.

Gifts and contributions of the farmer -

When the farmer donates products he has raised to a charitable organization, he is entitled to deduct the fair market value of such products. The expenses of production are deductible too, without adjustment.⁶⁵

Where the farmer makes an ordinary gift, he can deduct the expenses of raising the cattle given.⁶⁶

Wages paid minor children -

In the list heading this chapter under deductions not allowable will be found "value of labor of farmer, his wife, or minor children." This category should not be mistaken for wages paid to minor children, which may be deductible. The Commissioner has ruled that reasonable wages paid by a father to his unemancipated minor child for personal services, actually rendered as a bona fide employee in the conduct of the father's business,

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Prentice Hall Federal Tax Service, Vol. 1, 1950, p. 7158.

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I.T. 3910, CB 1948, p. 15.

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I.T. 3932, CB 1948-2, p. 7.

constitutes a deductible expense. He may at the same time be depriving himself of an exemption if the wages exceed \$500. The value of meals and lodging furnished this same minor child is not deductible as wages.

Hired labor -

A farmer may deduct room and board purchased for hired labor regardless of the usual distinction as to whether it is for the employer's or the employee's convenience. The laborer must draw the distinction in determining whether such items are income to him.

Expenses and Commodity Credit Loans -

If the farmer has obtained loans from the Commodity Credit Corporation and he elected to treat the loan as income, he may deduct his expenses connected with the crop for the year it's included in income. If the election has not been made, the farmer may deduct expenses of the crop this year, even though he won't have income until the crop is sold.

Crop expenses of crop basis farmer -

Expenses incurred in regard to crops planted in prior years may be deducted in the current year if the crop is sold in the current year. The Commissioner's consent is required.

Office expenses -

When a farm is operated as a business, office expenses in connection with the operation of the farm are deductible.

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I.T. 3767, CB 1945, p. 101.

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George W. Cutting et al., Sec. 47, 327 P-H Memo TC.

Development expenses -

Expenses incurred while developing farm to a productive state are deductible unless the option has been exercised to capitalize them. Once the election is made it is binding and the taxpayer will not be allowed to go back and amend his return to treat such items in a different way.

II. DEVELOPMENT EXPENDITURES

The Bureau divides the life of a farm, orchard or ranch into three periods: the preparatory, the development period, and the productive period. During the preparatory period, preparatory expenditures must be capitalized. Preparatory expenses are those expenditures made prior to the development stage, which are not considered ordinary and necessary expenses in the business field the taxpayer is entering.

When the development stage is entered the taxpayer has an option to capitalize ordinary and necessary business expenses. After the business enters the productive stage the ordinary and necessary business expenses can not be capitalized but must be deducted currently as expenses.

III. DEPRECIATION

The Regulation regarding depreciation by farmers states a definite rule that farm buildings, other than the owner's residence, farm machinery

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I.T. 1952, CB June 1924, p. 139.

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Min. 6030, Supp. 1, Dec. 11.337.

and other physical properties including livestock, are subject to a deduction⁷¹ for depreciation. The property must be used in the trade or business and it must not be included in inventory. If part of the farmer's dwelling is used in his farm operations he may depreciate such portion. Land is not depreciable; therefore when buildings are depreciated, the value of the land should not be included.

To compute depreciation, the cost or other tax basis must be ascertained and the depreciation allowed or allowable in prior years must be deducted. The result represents the value to be recovered by depreciation. To find the annual deductions for depreciation this last figure must be divided by the remaining useful life of the asset stated in years.

The Bureau has recognized that farm machinery depreciates whether crops are planted in that year or not and regardless of the manner of computing income, depreciation may be deducted only in the year of occurrence.⁷² Even though the life of an orchard is somewhat indefinite, there is no doubt that its useful life is limited. All expenses necessary to bring an orchard to its productive stage may be capitalized and thereafter a fair and reasonable annual deduction for depreciation will be allowed.⁷³

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Reg. 111, Sec. 29.23(1)-10.

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I.T. 1700 II - ICB 102.

⁷³

O. 797, CB 1919, p. 130; Kaweah Lemon Co., 5 BTA 992.

The following suggested useful lives for depreciable farm assets are presented in the Bureau Bulletin "F" as a guide to the farmer in handling his depreciation and obsolescence problems:

	Average useful life (years)
Animals	
Cattle, breeding or dairy.	8
Goats, breeding.	5
Hogs, breeding	5
Horses, breeding or work	10
Mules, work.	10
Sheep, breeding.	5
 Barrels, dip.	6
Beehives.	10
Benches	20
Binders:	
Corn	12
Grain.	14
Bins.	20
Boilers	20
Bunchers, clover.	15
Burners, oil.	15
 Cables.	3
Canals:	
Steel and concrete	50
Wood syphon.	25
Canning machines.	15
Carriers:	
Feed	20
Hay.	25
Litter	5
Carts:	
Dump and farm.	8
Hand	5
Cellars, root	30
Cesspools ,	15
Cisterns.	33
Cleaners and graders.	15
Clippers, horse	8
Conveyors and elevators	15
Covers, canvas.	8
Cribs, corn	30
Crushers, corn and cob.	15

	Average useful life (years)
Cultivators. . . . .	.15
Culverts:	
Masonry and cast-iron pipe. . . . .	.50
Galvanized corrugated iron. . . . .	.25
Riveted steel . . . . .	.33
Cups, turpentine	5
Cutters:	
Feed. . . . .	.12
Rotary stump. . . . .	.20
Diggers, potato. . . . .	.15
Distributors, fertilizer . . . . .	.12
Drills:	
Grain . . . . .	.15
Well. . . . .	.10
Dress plants . . . . .	.10
Elevator machinery, grain. . . . .	.18
Elevator and wagon dump, grain . . . . .	.12
Engines:	
Gasoline. . . . .	.10
Diesel. . . . .	.15
Stationary, steam . . . . .	.20
Traction, steam . . . . .	.20
Feeders.	8
Fence machines	5
Fence posts, steel . . . . .	.30
Fences:	
Snow.	8
Wood. . . . .	.15
Fencing, woven wire. . . . .	.15
Flumes . . . . .	.25
Forges, portable . . . . .	.12
Fumigators . . . . .	.10
Furnaces:	
Evaporator, dry . . . . .	.15
Heating . . . . .	.20
Furrow openers, disk . . . . .	.15
Gates, farm. . . . .	.15
Generators, gas, acetylene , . . . .	.15
Grinders, grain and feed . . . . .	.15
Groves (See Trees and vines.)	
Harness.	7

	Average useful life (years)
Harrows. . . . .	.15
Harvesters, grain. . . . .	.15
Headers. . . . .	.15
Hoists and forks, hay. . . . .	.12
Hullers, clover and alfalfa. . . . .	.15
Huskers. . . . .	.15
Ice boxes. . . . .	.12
Ice harvesting and hoisting machinery. . . . .	.10
Incubators and brooders. . . . .	.15
Laboratory equipment . . . . .	.10
Listers. . . . .	.15
Loaders, hay and seed. . . . .	.10
Milking machines . . . . .	.20
Mills and presses, cider . . . . .	.15
Mills:	
Corn, portable. . . . .	.12
Feed. . . . .	.15
Grist . . . . .	.25
Smut. . . . .	.15
Mowers:	
Farm. . . . .	.14
Lawn. . . . .	.8
Orchard tools. . . . .	.7
Orchards. (See Trees and vines.)	
Packing tools. . . . .	.10
Pens . . . . .	.20
Picking machines . . . . .	.5
Planters . . . . .	.15
Plows. . . . .	.15
Press, hay, baling . . . . .	.12
Pullers, beet. . . . .	.18
Pullers and grubbers, stump. . . . .	.20
Pumps:	
Bucket. . . . .	.22
Centrifugal or rotary . . . . .	.20
Plunger . . . . .	.15
Racks:	
Feed. . . . .	.10
Hay and stack . . . . .	.15
Rakes. . . . .	.15

	Average useful life(years)
Refrigerators, electric. . . . .	.15
Saddles. . . . .	.10
Saws, circular . . . . .	.15
Scales:	
Portable. . . . .	.15
Truck or wagon, . . . . .	.25
Seeders, all types . . . . .	.18
Separators, cream or grain . . . . .	.15
Setters, plant . . . . .	.12
Shearing machines, hand and power. . . . .	.18
Shellers, corn . . . . .	.20
Shredders. . . . .	.15
Silos:	
Concrete. . . . .	.50
Metal . . . . .	.25
Wooden. . . . .	.20
Sleds and sleighs. . . . .	.15
Smudge pots. . . . .	.10
Sorters, potato. . . . .	.20
Sowers:	
Grain, broadcast. . . . .	.15
Lime. . . . .	.8
Sprayers . . . . .	.15
Spreaders, manure. . . . .	.15
Stackers, hay. . . . .	.20
Subsoilers . . . . .	.10
Tanks:	
Grain -	
Concrete . . . . .	.50
Metal. . . . .	.25
Turpentine. . . . .	.5
Wagon . . . . .	.10
Water -	
Steel. . . . .	.40
Wood . . . . .	.20
Watering. . . . .	.20
Tarpaulins . . . . .	.8
Threshing machines . . . . .	.15
Tractors . . . . .	.10
Trees and vines:	
Almond. . . . .	.40
Apple . . . . .	.50
Apricot . . . . .	.25
Banana. . . . .	.10

	Average useful life (years)
Cherry. . . . .	.50
Fig . . . . .	.60
Grape . . . . .	.33
Grapefruit. . . . .	.40
Lemon . . . . .	.40
Nectarine . . . . .	.15
Olive . . . . .	.50
Orange. . . . .	.40
Peach . . . . .	.15
Pear. . . . .	.40
Plum. . . . .	.33
Prune . . . . .	.33
Walnut. . . . .	.40
Troughs, iron and steel. . . . .	.15
Vats, dipping. . . . .	.10
Wagon beds and racks . . . . .	.6
Wagon gear - wood wheels . . . . .	.12
Wagons:	
Light . . . . .	.12
Trucking, heavy duty. . . . .	.10
Weighers and baggage, grain. . . . .	.20
Windmills. . . . .	.20

If a farm is determined to be held for pleasure or recreation purposes and not for a business purpose, none of the expenses, including depreciation, will be allowed.⁷⁴ In extreme cases a deduction for obsolescence has been allowed as to land. Such a case would be where a farm used for raising wine grapes and not suitable for anything else is practically put out of business by prohibition legislation. This allowance would include the value of the vines and improvements.⁷⁵

IV. LOSSES

Losses incurred in the business of farming are deductible from

⁷⁴ Estate of Johnson V. Camden et al., 47 BTA 926, aff'd (CCA-6; 1943), 139 F.2d 697, 31 AFTR 1125.

⁷⁵ O. 862, CB 1919, p. 127.

gross income. The wording of the Regulation automatically excludes losses incurred in operating a farm when not done as a business.⁷⁶ This requirement is aimed at those who operate farms as hobbies, for pleasure or for recreation. The fact that losses occur is not determinative for the court⁷⁷ has said it is the expectation of gain that is important.

Losses incurred by the destruction of a prospective crop are not deductible since other treatment would result in a loss from anticipated profits. The same rule applies to losses of cattle raised by the farmer, although such loss will possibly be reflected in inventory. To the contrary a loss amounting to the cost of preparation and planting has been allowed⁷⁸ where a cranberry bog was completely destroyed due to seepage. Losses due to shrinkage in crops, which are being stored to await a more favorable market, are not allowable.

All losses connected with the business of farming are losses for adjusted gross income purposes. Losses from farming as a business may properly be used to offset gains of other businesses operated by the farmer. The farmer can take advantage of the same "carry-back" and "carry-forward" provisions as other taxpayers under the net operating loss provisions of the Code.⁷⁹

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Reg. 111, Sec. 29.23 (e)-5.

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Samuel Riker, Jr., Executor of Estate of J. Amory Haskell,
6 BTA 890.

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John B. Hadaway, 13 BTA 986.

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I.R.C., Sec. 122.

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APPENDIX

Page 2

SUMMARY OF INCOME AND DEDUCTIONS COMPUTED ON AN ACCRUAL BASIS

16-41264-2

UNITED STATES

SCHEDULE OF FARM INCOME AND EXPENSES

For Calendar Year 194__

**Attach This Form
to Your Income
Tax Return Form
1040 and File It
With the Collector
of Internal Revenue
for Your District**

Or for year beginning _____, 194__, and ending _____, 194__.

Name _____

Address _____

Location of farm or farms _____

Number of acres in each farm _____

**Fill in Pages 1 and 3
if Your Accounts Are
Kept on a Cash Basis.**

**If You Keep Books
on an Accrual Basis
and Desire to Use
This Form, Fill in
Pages 2 and 3 Instead**

FARM INCOME FOR TAXABLE PERIOD[illegible]

4. SALE OF LIVESTOCK AND OTHER ITEMS PURCHASED

1. Description	2. Date acquired	3. Gross sales price (contract price)	4. Cost or other basis	5. Depreciation allowed (or allowable) since acquisition or March 1, 1913	6. Profit (column 3 plus column 5 minus column 4)
		\$	\$	\$	\$
Total (enter on line 4 of summary below)					\$

SUMMARY OF INCOME AND DEDUCTIONS COMPUTED ON A CASH RECEIPTS AND DISBURSEMENTS BASIS

Sale of livestock raised.....	\$.....	6. Expenses (from page 3).....	\$.....
Sale of produce raised.....		7. Depreciation (from page 3).....	
Other farm income.....		8. Net operating loss deduction (attach statement).....	
Profit on sale of livestock and other items purchased.....			
GROSS PROFITS.....	\$.....	9. TOTAL DEDUCTIONS.....	\$.....
b. Net farm profit (line 5 minus line 9) to be reported on line 22, Schedule C, page 2, Form 1040.....			\$.....

METHOD OF ACCOUNTING

Farmers may compute their income either on the cash receipts and disbursements basis or the accrual basis, but whichever method is adopted in filing their first return must be followed until the consent of the Commissioner is received to compute income upon a new basis. Applications for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the closing of the taxable year to be covered by the return and should be addressed to the Commissioner of Internal Revenue, Washington 25, D. C.

CASH RECEIPTS AND DISBURSEMENTS BASIS

A farmer reporting on the basis of cash receipts and disbursements shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received from the sale of livestock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any livestock or other items which were purchased, and (3) gross income from all other sources. The farm expenses will be the actual amounts paid out during the taxable year.

Change in method of accounting.—Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided the requirements as to the timely filing of an application as outlined above have been complied with and provided further, that the taxpayer and the Commissioner agree upon the terms and conditions under which the change is to be effective.

ACCRUAL BASIS

For a farmer reporting on the accrual basis, the gross profits are obtained as indicated in summary of income and deductions on page 2 of this form. The farm expenses will be the actual expenses incurred during the year, whether paid or not. Farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method," which provides for the valuation of inventories at market price or direct cost of disposition. If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner. Farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit livestock price method."

INCOME

All the farm income from whatever source must be reported in this schedule. Anything of value received instead of cash must be treated as income to the extent of its market value. Thus, the market value of groceries, merchandise, or the like, received in exchange for farm produce must be reported as income. Recoveries for hail and fire insurance on growing crops should be included in gross income.

A taxpayer electing to include in gross income amounts received during the year as loans from Commodity Credit Corporation should file with his return a statement showing details of such loans. (See section 123 of the Internal Revenue Code.) Report gains and losses from sales or exchanges of capital assets and other property in separate Schedule D (Form 1040).

The value of farm produce consumed by the farmer and his family need not be reported as income; but expenses incurred in raising such produce must not be claimed as deductions.

The term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, truck farms, and all land used for farming operations. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer.

EXPENSES AND OTHER DEDUCTIONS

In general, a farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in carrying on the business of farming, except those which represent capital investment. The following is a list of such expenses (taken from the classification appearing on page 3 of this form though any other equally descriptive classification may be used).

Labor hired.—Amounts paid for regular farm labor, piece work, contract labor, and other forms of hired labor. Do not deduct the value of your own labor or that of your wife or dependent minor children. Only that part of the board which is purchased for hired labor should be deducted. The value of products furnished by the farm and used in the board of hired labor is not deductible. Rations purchased and furnished to laborers or sharecroppers are deductible. Do not deduct amounts paid to persons engaged in household work, except to the extent that the services of such persons are used in boarding and otherwise caring for farm laborers. Services of such employees engaged in caring for the farmer's own household are not deductible.

Feed purchased.—Cost of grain, hay, silage, mill feeds, other concentrates and roughages purchased, and amounts paid for grinding, mixing, and processing of feed.

Machine hire.—Amounts paid for threshing, combining, silo filling, baling, ginning, and other machine hire.

Supplies purchased.—Cost of twine, spray material, poisons, disinfectant, cans, barrels, baskets, egg cases, bags, and other similar farm supplies purchased.

Cost of repairs and maintenance.—Amounts expended for repairs and maintenance of farm buildings (except your dwelling), fences, drains, and other farm improvements, and for repairs and maintenance of farm machinery and equipment; cost of small tools of short life such as shovels, rakes, etc. Amounts expended for replacements of, or additions to, farm machinery, farm buildings, or other farm equipment of a permanent nature are not deductible.

Fertilizers and lime.—Cost of commercial fertilizers, lime, and manure purchased during the year, the benefit of which is of short duration, is deductible. The amount expended in the restoration of soil fertility preparatory to actual production of crops and the cost of liming soil to increase productiveness over a period of years are capital expenditures.

Taxes.—State and local taxes. Do not deduct Federal income taxes; estate, inheritance, legacy, succession, and gift taxes; nor taxes assessed for any improvement or betterment tending to increase the value of the property assessed. Do not deduct on this form, taxes on your dwelling or household property and other personal taxes. Taxes, such as those on retail sales, which apply to items used in the farm business, may be considered as part of the cost of such items.

Insurance on farm property.—Cost of all insurance on farm buildings (except your dwelling) and improvements, equipment, crops, and livestock.

Interest on farm notes and mortgages.—Interest paid on farm mortgages, notes, and other obligations incurred to carry on the farm business.

Water rent, electricity, and telephone.—Report only the farm share of these expenditures.

Rent of farm, part of farm, or pasturage.—Rent paid in cash. Where a tenant farmer pays rent to the landlord in the form of crops raised on the farm (the agreement being on a cropshare basis), the tenant may not deduct as rent the value of the crop given to the landlord, but the tenant may deduct all amounts paid by him in raising the crop.

Automobile upkeep.—For automobiles used exclusively in farm business, all expenses of operation, repair, and depreciation. For automobiles used both for farm business and for personal use, only that part of the expense corresponding to the business use may be deducted. If some items, such as gasoline or repairs, are included under other headings, include here only those expenses not shown elsewhere. The farm share of automobile depreciation should be entered in the depreciation table.

Other farm expenses.—Fees paid for advertising farm products; expenditures for stamps, stationery, account books, and other office supplies purchased for farm use; expenditures for travel in connection with the farm business; and other similar miscellaneous expenditures. Amounts expended for purchase of automobiles, farm machinery, farm buildings, or other farm equipment of a permanent nature are not deductible.

Depreciation.—Allowance for depreciation of buildings, improvements, machinery, or other farm equipment of a permanent nature. The amount claimed on account of depreciation should not exceed original cost (not replacement cost) of the property, or if acquired prior to March 1, 1913, the cost or value as of that date, divided by the probable number of years remaining of its useful life. In computing depreciation do not include the value of farm land nor the land on which farm buildings are located. Do not deduct repairs or depreciation on the dwelling you occupy or on your personal or household equipment. Do not claim as a separate item depreciation on livestock or any other property included in your inventory. Depreciation, however, may be claimed on livestock acquired for work, breeding, or dairy purposes which are not included in your inventory of livestock purchased or raised for sale.

Bad debts.—Report only debts, or portions thereof, arising from sales reported as income, which have been definitely proved within the year to be worthless, or such reasonable amount as has been added to a reserve for bad debts within the year. If you report your farm income on the cash basis, bad debts arising from sales are not an allowable deduction.

Losses.—Do not deduct on this form losses of buildings, machinery, and other property not included in your inventory, resulting from fire, storm, or other casualty and not compensated for by insurance or otherwise. Losses of property included in your inventory are taken care of by the reduced amount of the inventory at the close of the year. The total loss of a prospective crop by frost, storm, flood, or fire, is not deductible. When reporting on the cash basis, the value of animals raised by you and lost by death is not deductible, while in the case of animals purchased and lost by death, the cost less depreciation allowed or allowable is deductible.

Net operating loss deductions.—Every farmer claiming a net operating loss deduction shall file with his return a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction under section 122 of the Internal Revenue Code.

Sec.29.22(a)-7. Gross income of farmers.--A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased after February 28, 1913, is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory is used to determine profits), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the

cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired, for draft, breeding, or dairy purposes and not for sale, may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. (See section 29.22(c)-6.)

In every case of the sale of machinery, farm equipment, or other capital assets purchased after February 28, 1913 (which are not to be included in an inventory if one is used to determine profits), any excess over the cost thereof less the amount of depreciation theretofore allowed (but not less than the amount allowable) in respect of such property as a deduction in computing net income, shall be included as gross income. If farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income. Rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or the equivalent of money. Proceeds of insurance, such as hail and fire insurance on growing crops, should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed. If a farmer is engaged

in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may, with the consent of the Commissioner (see section 29.41-2), be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized.

As herein used the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer.

Form 1040F should be filled in and attached to his income tax return by every farmer who either keeps no records or only records of cash receipts and disbursements; its use is optional with other farmers. (See further sections 29.23(a)-11, 29.23(e)-5, and 29.23(1)-10.)

Sec.29.22(b)(4)-1. Interest upon State obligations.--Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of

a State, Territory, or political subdivision. The term "political subdivision," within the meaning of the exemption, denotes any division of the State or Territory which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State or Territory. As thus defined, a political subdivision of a State or Territory may or may not, for the purpose of exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory.

Sec.29.22(b)(4)-2. Dividends from shares of stock of Federal agencies or instrumentalities.--(a) Issued prior to March 28, 1942.--Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 12 U.S.C., 1940 ed., 931), provides that Federal land banks and national farm-loan associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 7 of the Federal Reserve Act of December 23, 1913 (38 Stat. 258, 12 U.S.C., 1940 ed., 531), provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 5(h) of the Home Owners' Loan Act of 1933 (48 Stat. 133, 12 U.S.C., 1940 ed., 1464(h)) provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes,

estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, national farm-loan associations, and Federal reserve banks is not, in the case of stock issued prior to March 28, 1942, subject to the income tax; and income consisting of dividends on share accounts of Federal savings and loan associations is not, in the case of shares issued prior to March 28, 1942, subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 and subsection (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see subsection (b) of this section.

Regardless of the exemption from income tax of dividends paid on the stock of Federal reserve banks, dividends paid by member banks are treated like dividends of ordinary corporations.

Dividends on the stock of the central bank for cooperatives, the production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933, constitute income to the recipients, subject to both the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (48 Stat. 267, 12 U.S.C., 1940 ed., 1138c)).

(b) Issued on or after March 28, 1942.--By virtue of the provisions of section 6 of the Public Debt Act of 1942, the tax exemption provisions set forth in subsection (a) of this section with respect to income consisting of dividends on stock of the Federal land banks, national farm-

loan associations, and Federal reserve banks, or on share accounts of Federal savings and loan associations, are not applicable in the case of dividends on such stock or shares issued on or after March 28, 1942.

For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for.

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Sec.29.22(b)(4)-3. Interest upon notes secured by mortgages executed to Federal agencies or instrumentalities.--Section 26 of the Federal Farm Loan Act of July 17, 1916 (39 Stat. 380, 12 U.S.C., 1940 ed., 931), and section 210 of such Act, as added by section 2 of the Act of March 4, 1923 (42 Stat. 1459, 12 U.S.C., 1940 ed., 1111), provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

Sec.29.22(c)-2. Valuation of inventories.--Section 22(c) provides two tests to which each inventory must conform:

- (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and
- (2) It must clearly reflect the income.

.....

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22(c) are (a) cost and (b) cost or market, whichever is lower.

.....

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the elective method authorized by section 22(d) or to animals inventoried under the elective "unit-livestock-price method" authorized by section 29.22(c)-6. Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in section 29.41-2. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual

cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22(d) as to inventories under elective method. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

Sec.29.22(c)-3. Inventories at cost.--Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except

strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are (a) farmers and raisers of livestock (see section 29.22(c)-6), (b) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes or grades, the unit cost of which is substantially alike (see section 29.22(c)-7), and (c) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see section 29.22(c)-8).

Sec.29.22(c)-4. Inventories at cost or market, whichever is lower.--

Upon ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases--

- (a) Of goods purchased and on hand, and
- (b) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i. e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

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Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Sec.29.22(c)-6. Inventories of livestock raisers and other farmers.--

A farmer may make his return upon an inventory basis instead of the cash receipts and disbursements basis. It is optional with the taxpayer which of these methods of accounting is used, but, having elected one method, the option so exercised will be binding upon the taxpayer for the

year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in section 29.41-2.

Formal application for permission to change from the cash receipts and disbursements basis to an inventory basis of accounting shall not be required in the case of a change made for a taxable year beginning before December 30, 1948, the date of approval of Treasury Decision 5683.

In any change of accounting from the cash receipts and disbursements basis to an inventory basis, whether made for a taxable year beginning before or after December 30, 1948, adjustments shall be made, at the option of the taxpayer, in accordance with one or the other of the two methods outlined in (1) and (2) below:

(1) Opening and closing inventories shall be used for the year in which the change is made. There should be included in the opening inventory all farm products (including livestock) purchased or raised which were on hand at the date of the inventory, and there must be submitted with the return for the current taxable year an adjustment sheet for the preceding taxable year based on the inventory method, upon the amount of which adjustment the tax shall be assessed and paid (if any be due) at the rate of tax in effect for that year. Ordinarily an adjustment sheet for the preceding year will be sufficient, but if, in the opinion of the Commissioner, such adjustment is not sufficient clearly to reflect income, adjustments for earlier years may be accepted or required. If it is impossible to render complete inventories for the preceding year

or years, the Commissioner will accept estimates which, in his opinion, substantially reflect the income on the inventory basis for such preceding year or years; but inventories must not include real estate, buildings, permanent improvements, or any other assets subject to depreciation.

(2) No adjustment sheets will be required, but the net income for the taxable year in which the change is made must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory of livestock, crops, and products at the beginning of the year; provided, however--

(a) That if any livestock, grain, or other property on hand at the beginning of the taxable year had been purchased and the cost thereof not charged to expense, only the difference between the cost and the selling price should be reported as income for the year in which sold;

(b) But if the cost of such property had been charged to expense for a previous year, the entire amount received must be reported as income for the year in which sold.

Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the "farm-price method," and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method."

The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing

inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method." If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in section 29.41-2.

The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonable account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately \$15 to product a calf, and \$7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: calves, \$15; yearlings, \$22.50; 2-year olds, \$30; mature animals, \$37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the Commissioner upon examination of the taxpayer's return.

A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft or dairy purposes. Once established, the unit prices and classifications

selected by taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for breeding, dairy, or draft purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each accounting year in accordance with the established unit prices, except that no increase is to be made in the year of purchase, if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in first-out method of valuing inventories must be applied.

If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in section 29.41-2. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock for taxable years beginning after December 31, 1943 without

formal application for permission, but the classifications and unit prices selected are subject to approval by the Commissioner upon examination of the taxpayer's return. A livestock raiser who has, for taxable years beginning prior to January 1, 1944, adopted a constant unit price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method."

If returns have been made in which the taxable net income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

(Amended by T. D. 5423, 12-15-44; T. D. 5683, 12-30-48.)

Sec. 29.23(a)-11. Expenses of farmers.--A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The cost of feeding and raising live stock may be treated as an expense deduction, in so

far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 29.41-2), be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital and may be depreciated unless such animals are included in an inventory in accordance with section 29.22(a)-7. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a farm is operated for recreation or pleasure and not on a

commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. (See also sections 29.22(a)-7, 29.23(e)-5, and 29.23(1)-10.)

Sec.29.23(a)-15. Nontrade or nonbusiness expenses.--(a) In general.-- Subject to the qualifications and limitations in chapter 1 and particularly in section 24, an expense may be deducted under section 23 (a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

. . . The expenses, however, of carrying on transactions, which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23 (a) (2), must be "ordinary and necessary," which presupposes that they must be reasonable in amount

and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(b) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24. Section 24(a)(5) disallows any amount otherwise allowable as a deduction (whether under section 23 (a) (2) or otherwise) which is allocable to one or more classes of taxexempt income, other than interest, and has the effect in addition of disallowing a deduction under section 23 (a) (2) for amounts otherwise allowable under that section which are allocable to tax-exempt interest. Thus, any amount allocable to the production or collection of one or more classes of income which is not includible in gross income or to the management, conservation, or maintenance of property held for the production of such income is not deductible under section 23 (a) (2). Nor does section 23 (a) (2) allow any expenses which are disallowed by any of the provisions of chapter 1.

Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are

not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

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Sec.29.23(e)-5. Losses of farmers.--Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value of by reason of deterioration in storage shall be allowed, except as such shrinkage may be reflected in an inventory if used to determine profits. The total loss by frost, storm, flood, or fire of a prospective crop is not a deductible loss in computing net income. A farmer engaged in raising and selling stock, such as cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm, except as such loss is reflected in an inventory if used. If live stock has been purchased after February 28, 1913, for any purpose,

and afterwards dies from disease, exposure, or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such live stock, less any depreciation allowable as a deduction in respect of such perished live stock, may be deducted as a loss if the loss is not compensated for by insurance or otherwise. The actual cost of other property (with proper adjustment for depreciation) (which is destroyed by order of the authorities of a State or of the United States, may in like manner be claimed as a loss. If reimbursement is made by a State or the United States in whole or in part on account of stock killed or other property destroyed in respect of which a loss was claimed for a prior year, the amount received shall be reported as income for the year in which reimbursement is made. The cost of any feed, pasture, or care which has been deducted as an expense of operation shall not be included as part of the cost of the stock for the purpose of ascertaining the amount of a deductible loss. If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure. As to losses claimed as deductions for estate tax purposes, see section 29.23(e)-1. See also sections 29.22(a)-7, 29.23(a)-11, and 29.23(1)-10.

Sec.29.23(i)-1. Basis for determining loss.--The basis for determining the amount of the deduction for losses allowed to individuals under section 23(e) and to corporations under section 23(f), or of the amount of the deduction for bad debts allowed to both individuals and corporations under section 23(k), is the same as is provided in section 113 for determining the loss from the sale or other disposition of property. Proper adjustment must be made in each case for any expenditure, receipt, loss, or other item properly chargeable to capital account, and for depreciation, obsolescence, amortization, or depletion. (See section 113(b) and sections 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive.)

Sec.29.23(1)-1. Depreciation.--A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. . . .

Sec.29.23(1)-2. Depreciable property.--The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where ma-

achinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements of physical development added to it. . . .

Sec.29.23(1)-4. Capital sum recoverable through depreciation allowances.--The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113(a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual eshaustion of its utility which is the basis of the depreciation allowance. (See section 113(b).). . .

Sec.29.23(1)-10. Depreciation in the case of farmers.--A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property. A reasonable allowance for depreciation may also be claimed on live stock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with section 29.22(a)-7. Such depreciation should be based on the cost or other basis and the estimated life of the live stock. If such live stock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. (See also sections 29.23(a)-11 and 29.23(e)-5.)

Sec.29.41-3. Methods of accounting.--It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and section 29.54-1.)

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Sec.29.41-4. Accounting period.--The return of a taxpayer is made and his income computed for his taxable year, which in general means his fiscal year, or the calendar year if he has not established a fiscal year. (See section 48.) The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. A person having no such fiscal year must make his return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis upon which he made his return for the taxable year immediately preceding, unless, with the approval of the Commissioner, he has changed his accounting period. See section 29.46-1.

Sec.29.54-1. Records and income tax forms.--Every person subject to the tax, except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1. . . . The books or records required by this section shall be kept at all times available for inspection by internal-revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal-revenue law.

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Sec.29.58-6. Time and place for filing declarations--Year beginning prior to January 1, 1944.--(a) Time for filing declaration.--(1) General.--Declarations of estimated tax must (except in the case of farmers as to whom see subsection (a) (3) of this section) be made on or before the 15th day of the third month of the taxable year by every individual whose then anticipated income for the current taxable year, or whose actual income for the preceding taxable year, meets the requirements of section 58 (a). The requirement with respect to the time for filing the declaration applies alike to nonresident aliens who are required to make the declaration as well as to United States citizens and residents.

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(3) Farmers.--While, generally, the declaration of estimated tax must be filed on or before the 15th day of the third month of the taxable year, the statute provides that in the case of an individual whose estimated gross income from farming for the taxable year is at least 30 percent of his total estimated gross income from all sources for such year, there is permitted the election of filing a declaration on or before the 15th day of the last month of the taxable year in lieu of the time prescribed for individuals generally. The estimated gross income from farming is the estimated income resulting from the cultivation of the soil and the raising or harvesting of any agricultural or horticultural commodities, and the raising of livestock, bees, or poultry. In other words, the requisite gross income must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range, or orchard. If an individual receives for the use of his land income in the form of a share of the crops produced thereon, such income is from farming. As to determination of income of farmers, see sections 29.22(a)-7. and 29.23(a)-11.

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Sec.29.58-7. Time and place for filing declarations--

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(b) Calendar and fiscal years beginning after December 31, 1944.--

Declarations of estimated tax for the calendar year 1945 and subsequent calendar years shall (except in the case of farmers, as to whom see subsection (c) of this section) be made on or before March 15 of such year by every individual whose then anticipated income for the current calendar year meets the requirements of section 58 (a), as amended.

.....

(c) Farmers.--In the case of an individual, whose estimated gross income from farming for the taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the 15th day of January of the succeeding taxable year in lieu of the time prescribed for individuals generally. The provisions of section 29.58-6 (a) (3) relating to what constitutes farming are equally applicable to taxable years beginning after December 31, 1943.

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In the case of an individual whose estimated gross income from farming for a short taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the 15th day of the month immediately following the close of such taxable year.

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Sec.29.58-10. Payment of estimated tax--Years beginning prior to January 1, 1944.

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(b) Farmers.--In the case of an individual whose estimated gross income from farming is at least 80 percent of his total gross income from all sources for the taxable year, special provisions are made with respect to the filing of the declaration, the payment of the tax and the penalties incurred. As to what constitutes income from farming within the meaning of this subsection, see section 29.58-6 (a) (3). In such case the declaration is to be filed on or before the 15th day of the last month of the taxable year, and the entire amount of the estimated tax must be paid at that time.

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Sec.29.58-11. Payment of estimated tax--Years beginning after December 31, 1943.

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(b) Farmers.--In the case of an individual whose estimated gross income from farming for taxable years beginning after December 31, 1943, is at least two-thirds of his total gross income from all sources for such taxable year, special provisions are made with respect to the filing of the declaration, the payment of the tax, and the penalties incurred. As to what constitutes income from farming within the meaning of this subsection, see section 29.58-6 (a) (3). In such case, if such taxable year is the calendar year, the declaration is to be filed on or before

January 15 of the succeeding calendar year and payment of the estimated tax shall be made in full at such time. In the case of a farmer on the fiscal year basis, the declaration may be filed on or before the 15th day of the succeeding fiscal year and payment of the estimated tax shall be made in full at such time.

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Sec.29.101(1)-1. Labor, agricultural, and horticultural organizations.--
The organizations contemplated by section 101 (1) as entitled to exemption from income taxation are those which--

- (1) Have no net income inuring to the benefit of any member;
- (2) Are educational or instructive in character; and
- (3) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Organizations such as county fairs and like associations of a quasi public character, which are designed to encourage the development of better agricultural and horticultural products through a system of awards, and whose income from gate receipts, entry fees, and donations is used exclusively to meet the necessary expenses of upkeep and operation, are thus exempt. On the other hand, associations which have for their purpose, for example, the holding of periodical race meets, the profits from which may inure to the benefit of their shareholders, are not exempt. Similarly, corporations engaged in growing agricultural or horticultural products for profit are not exempt from tax.

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Sec.29.101(9)-1. Social clubs.--The exemption granted by section 101(9) applies to practically all social and recreation clubs which are supported by membership fees, dues, and assessments. If a club engages in traffic, in agriculture or horticulture, or in the sale or real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes. Generally, an incidental sale of property will not deprive the club of the exemption.

Sec.29.101(12)-1. Farmers' cooperative marketing and purchasing associations.--(a) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Internal Revenue Code and is not exempt. In other words, nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the

the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption, (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all

of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a non-producer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such

purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101(12).

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, live stock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101(12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of subsection (a) of this section relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either subsection (a) or (b) of this section an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in subsection (a). An association engaged both in marketing farm products

and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Internal Revenue Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101(12) and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101(12).

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, such as marketing building materials, are not exempt.

(Amended by T. D. 5458, June 15, 1945.)

Sec. 29.101(13)-1. Corporations organized to finance crop operations.-- Corporations organized by farmers' cooperative marketing or purchasing associations, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers are also exempt, provided the marketing or purchasing association is exempt under section 101(12), and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of section 29.101(12)-1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

Sec.29.112(f)-1. Reinvestment of proceeds of involuntary conversion.--

Upon the involuntary conversion of property described in section 112(f), no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 112(f), the gain, if any is recognized to the extent of the money which is not so expended.

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The provisions of section 112(f) are applicable to property used for residential or farming purposes.

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Sec.29.119-11. Other income from sources within the United States.--

Items of gross income other than those specified in section 119(a) and (c) shall be allocated or apportioned to sources within or without the United States, as provided in section 119(e).

The income derived from the ownership or operation of any farm, mine, oil, or gas well, other natural deposit, or timber, located within or without the United States, thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in section 29.119-12.

Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income.

Sec.29.123-1. Election to include loans in income.--A taxpayer who receives a loan from the Commodity Credit Corporation may, at his election, include the amount of such loan in his gross income for the taxable year in which the loan is received. If a taxpayer makes such an election, then for subsequent taxable years he shall include in his gross income all amounts received during those years as loans from the Commodity Credit Corporation, unless he secures the permission of the Commissioner to change to a different method of accounting. Application for permission to change such method of accounting and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return.

Sec.29.123-2. Effect of election on adjustments for other taxable years.--If a taxpayer elects or has elected under section 123 of the Internal Revenue Code or section 223(d) of the Revenue Act of 1939, as amended, to include in his gross income the amount of a loan from the Commodity Credit Corporation, for the taxable year in which it is received, then--

(1) no part of the amount realized by the Commodity Credit Corporation upon the sale or other disposition of the commodity pledged for such loan shall be recognized as income to the taxpayer, unless the taxpayer receives an amount in addition to that advanced to him as the loan, in which event such additional amount shall be included in the gross income of the taxpayer for the year in which received; and

(2) no deductible loss to the taxpayer shall be recognized on account of any deficiency realized by the Commodity Credit Corporation on such loan if the taxpayer was relieved from liability for such deficiency.

Example. A, a taxpayer who elected for his taxable years 1938, 1939, and 1940 to include in gross income amounts received during those years as loans from the Commodity Credit Corporation, received as loans \$500 in 1938, \$700 in 1939, and \$900 in 1940. In 1942 all the pledged commodity was sold by the Commodity Credit Corporation for an amount \$100 and \$200 less than the loans with respect to the commodity pledged in 1938 and 1939, respectively, and for an amount \$150 greater than the loan with respect to the commodity pledged in 1940. A, in making his return for 1942, shall include in gross income the sum of \$150 if it is received during that year, but will not be allowed a deduction for the deficiencies of \$100 and \$200 unless he is required to satisfy such deficiencies and does satisfy them during that year.

Sec.29.143-3. Exemption from withholding.--

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The salary or other compensation for personal services of a nonresident alien individual who enters and leaves the United States at frequent intervals, shall not be subject to deduction and withholding of income tax at the source if--

- (1) such nonresident alien is a resident of Canada or Mexico, or
- (2) such nonresident alien is engaged in agricultural labor as defined in section 1426 (h) of the Internal Revenue Code.

Payments made by the United States or other public or private agencies or employers to nonresident aliens brought into the United States for the purpose of the production and harvesting of agricultural commodities pursuant to Public Law 45 (78th Congress), approved April 29, 1943, shall not be subject to deduction and withholding of income tax at the source (see section 5(b) of such Public Law 45).

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Sec.29.294-1. Additions to the tax.--(a) General.--Section 294(c) provides for certain additions to the tax in the case of--

- (1) failure to file timely a declaration of estimated tax;
- (2) failure to pay within the time prescribed any installment of declared estimated tax; and
- (3) substantial underestimate of the estimated tax.

These additions to the tax are in addition to any applicable criminal penalties.

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(3) Substantial understatement of estimated tax.--Section 294(d) (2) provides for an addition to the tax in the case of a taxpayer who makes a substantial underestimate of tax on his declaration. Such addition to the tax shall not apply to the taxable year in which falls the death of the taxpayer.

For taxable years beginning after December 31, 1942, except as hereinafter provided--

(A) In the case of individuals, other than those exercising the election under section 60 (a), relating to farmers, an addition to the tax under section 294 (d) (2) is applicable in the event that the amount of the estimated tax (increased by the amount of the credit for taxes withheld at source on wages and the credit under section 32) is less than 80 percent of the tax imposed by chapter 1 for the taxable year (determined without regard to such credits). In the event of a failure to file the required declaration, the amount of the estimated tax for the purposes of this provision is zero.

(B) In the case of individuals exercising the election under section 60 (a), relating to farmers, the addition to the tax is applicable if the amount of the estimated tax increased by the amount of the credit for taxes withheld at source on wages and the credit under section 32 is less than $66 \frac{2}{3}$ percent of the amount of the tax (determined without regard to such credits).

(C) The addition to the tax in any case in which there has been such underestimation as comes within the scope of section 294 (d) (2) is an amount equal to--

(i) the excess of 80 percent of the tax (or $66 \frac{2}{3}$ percent in the case of farmers exercising an option under section 60 (a) determined without regard to the credit for taxes withheld at source on wages and the credit under section 32 over the amount of the estimated tax increased by such credits; or

(ii) 6 percent of the excess of the tax determined without regard to the credit for taxes withheld at source on wages and the credit under section 32 over the amount of the estimated tax increased by such credits, whichever ((i) or (ii)) is the lesser.

In the case of a taxpayer filing a declaration of estimated tax for a taxable year beginning in 1944, the term "tax" as it appears in the expressions "80 percent of the tax" in (A) and (C) (i), " $66 \frac{2}{3}$ percent of the amount of the tax" in (B), and "6 percent of the excess of the tax" in (C) (ii), shall be taken to refer to the lesser of the following: A tax computed under the law applicable to such taxable year without regard to the amendments made by the Income Tax Act of 1944, and a tax computed under the law applicable to such year.

The addition to the tax for substantial underestimate of the estimated tax shall not apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter of such year in an amount at least as great as though such estimated tax were

computed under the law applicable to the taxable year on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of filing the declaration, and on the basis of the tax withheld, and reasonably expected on the date of the filing of the declaration to be withheld, on wages received during the calendar year ending with or within the taxable year, but otherwise as though such estimated tax were computed on the basis of the net income, and the surtax net income, shown on the taxpayer's return for the preceding taxable year, adjusted to conform to the law applicable to the taxable year. The net income and the surtax net income shown on the taxpayer's return for the preceding taxable year shall be considered to be zero for the purposes of this section if for such year the taxpayer did not file a return and was not required to file a return. In the case of farmers exercising an election under section 60 (a), such addition to the tax shall not apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within the last quarter of such year in an amount at least as great as though computed under the law applicable to the taxable year on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of filing the declaration, but otherwise as though computed on the basis of the net income and the surtax net income shown on the taxpayer's return for the preceding taxable year, adjusted to conform to the law applicable to the taxable year. In the case of a taxable year beginning in 1943, those quarters of the taxable year which began before July 1, 1943, are exclu-

ded for the purpose of determining the application of the relief provision under section 294 (d) (2). As used in this subsection the expression "personal exemption and credit for dependents" shall for taxable years beginning after December 31, 1943, be taken to refer to the normal-tax exemption and surtax exemptions; also for such years, the expression "each quarter" shall be taken to include the period (ending with the 15th day of the first month of the succeeding taxable year) within which the last installment of the estimated tax is required to be paid, and the expression "last quarter" shall mean the period (similarly ending with the 15th day of the first month of the succeeding taxable year) within which farmers exercising an election under section 60 (a) are required to pay the estimated tax.

The application of section 294 (d) (2) for a taxable year beginning in 1943 in the case of taxpayers not entitled to elect under section 60 (a), relating to farmers may be illustrated by the following examples:

.....

Sec.405.102. Exclusions from Wages.--

.....

(c) Remuneration paid for agricultural labor.--(1) In general.--The term "wages" does not include remuneration for services which constitute agricultural labor as defined in section 1426 (h). The term "agricultural labor" as so defined includes services of a character described in paragraphs (2), (3), (4), and (5) of this subsection. In general,

however, the term "agricultural labor" does not include services performed in connection with forestry, lumbering, or landscaping.

(2) Services described in section 1426 (h) (1).--Remuneration paid for services performed on a farm by an employee of any person in connection with any of the following activities is excepted as remuneration for agricultural labor:

(i) The cultivation of the soil;

(ii) The raising, shearing, feeding, caring for, training, or management of livestock, bees, poultry, fur-bearing animals, or wildlife;

or

(iii) The raising or harvesting of any other agricultural or horticultural commodity.

The term "farm" as used in this subsection includes stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, orchards, and such greenhouses and other similar structures as are used primarily for the raising of agricultural or horticultural commodities. Greenhouses and other similar structures used primarily for other purposes (for example, display, storage, and fabrication of wreaths, corsages, and bouquets), do not constitute "farms".

(3) Services described in section 1426 (h) (2).--The remuneration paid for the following services performed by an employee in the employ of the owner or tenant or other operator of one or more farms is excepted as remuneration for agricultural labor, provided the major part of such services is performed on a farm:

(i) Services performed in connection with the operation, management,

conservation, improvement, or maintenance of any of such farms or its tools or equipment; or

(ii) Services performed in salvaging timber, or clearing land of brush and other debris, left by a hurricane.

The services described in (i) above may include, for example, services performed by carpenters, painters, mechanics, farm supervisors, irrigation engineers, bookkeepers, and other skilled or semiskilled workers, which contribute in any way to the conduct of the farm or farms, as such, operated by the person employing them, as distinguished from any other enterprise, in which such person may be engaged. Since the services described in this paragraph must be performed in the employ of the owner or tenant or other operator of the farm, the exception does not extend to remuneration paid for services performed by employees of a commercial painting concern, for example, which contracts with a farmer to renovate his farm properties.

(4) Services described in section 1426 (h) (3).--Remuneration paid for services performed by an employee in the employ of any person in connection with any of the following operations is excepted as remuneration for agricultural labor without regard to the place where such services are performed:

- (i) The ginning of cotton;
- (ii) The hatching of poultry;
- (iii) The raising or harvesting of mushrooms;
- (iv) The operation or maintenance of ditches, canals, reservoirs,

or waterways used exclusively for supplying or storing water for farming purposes;

(v) The production or harvesting of maple sap into maple sirup or maple sugar (but not the subsequent blending or other processing of such sirup or sugar with other products); or

(vi) The production or harvesting of crude gum (oleoresin) from a living tree or the processing of such crude gum into gum spirits of turpentine and gum rosin, provided such processing is carried on by the original producer of such crude gum.

(5) Services described in section 1426 (h) (4).--(i) Remuneration paid for services performed by an employee in the employ of a farmer or a farmers' cooperative organization or group in the handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of any agricultural or horticultural commodity, other than fruits and vegetables (see subdivision (ii) below), produced by such farmer or farmer-members of such organization or group of farmers is excepted, provided such services are performed as an incident to ordinary farming operations.

Generally services are performed "as an incident to ordinary farming operations" within the meaning of this paragraph if they are services of the character ordinarily performed by the employees of a farmer or of a farmers' cooperative organization or group as a prerequisite to the marketing, in its unmanufactured state, of any agricultural or horticultural commodity produced by such farmer or by the members of such farmers' organization or group. Services performed by employees of such farmer or farmers' organization or group in the handling, planting,

drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of commodities produced by persons other than such farmer or members of such farmers' organization or group are not performed "as an incident to ordinary farming operations".

(ii) Remuneration paid for services performed by an employee in the employ of any person in the handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market, of fruits and vegetables, whether or not of a perishable nature, is excepted as remuneration for agricultural labor, provided such services are performed as an incident to the preparation of such fruits and vegetables for market. For example, if services in the sorting, grading, or storing of fruits, or in the cleaning of beans, are performed as an incident to their preparation for market, remuneration paid for such services may be excepted whether the services are performed in the employ of a farmer, a farmers' cooperative, or a commercial handler of such commodities.

(iii) The services described in subdivisions (i) and (ii), above, do not include services performed in connection with commercial canning or commercial freezing, or in connection with any commodity after its delivery to a terminal market for distribution for consumption. Moreover, since the services described in such subdivisions must be rendered in the actual handling, planting, drying, packing, packaging, processing, freezing grading, storing, or delivering to storage or to market or to

a carrier for transportation to market, of the commodity, such services do not, for example, include services performed as stenographers, bookkeepers, clerks, and other office employees, even though such services may be in connection with such activities. However, to the extent that the services of such individuals are performed in the employ of the owner or tenant or other operator of a farm and are rendered in major part on a farm, they may be within the provisions of paragraph (3) of this subsection.